



LANGUAGE OF THE STOCK MARKET

FAMILY ECONOMICS &
FINANCIAL EDUCATION

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WHY LEARN ABOUT STOCKS?

One hears about the stock market on a daily basis. Not necessarily because they want to, but because it has become an integral part of American society. The market is the core of economic stability in the United States. Stocks and bonds represent companies which touch aspect of every person's life.

The **stock market** is a general term used to describe all transactions involving the buying and selling of stock shares issued by a company. A **stock** is a share of ownership in the assets and earnings of a company. It is represented by a piece of paper called the **stock certificate**. A **bond** is a type of debt that a company issues to investors for a specified amount of time. The company pays annual interest on the loan until the **maturity date** is reached when the principal is paid back to the

bondholder (lender).

When a company would like to grow, there are several methods which could be used to raise the funds and pay for ongoing business activities. One of the most preferred methods is to sell shares of ownership, called stock, to investors. Two reasons why issuing stock is popular are the company does not have to repay the money and paying dividends is optional. Investors that purchase stock earn money from increases in the stock's value and/or dividends.

An individual who keeps all of his/her earnings in an ultraconservative savings and investment option, such as a Certificate of Deposit, will have low earnings which will barely cover taxes and inflation. Therefore, the increased earning potential has made investing in the stock market an essential element to

portfolio diversification. A person with a diversified portfolio has money invested in a variety of investment tools to decrease risk. Stocks are very marketable because they can be bought and sold with ease.

Investing in stocks increases an individual's potential future earning power. There is also an increased risk the individual will lose his/her money.

Determining which stock to purchase can be very difficult because there are more than 7,000 companies available which offer stocks. To decrease the potential risks associated with investing in the stock market, a person must be able to research and track stocks. Two basic types of stock an investor may choose to put his/her money into are common and preferred.

Common stock refers to shares or units of ownership in a public corporation. This is the most typical kind of stock.

An individual who has invested in common stock has one vote per share owned to determine the company's board of directors. The value of a stock can change in four ways. The dollar value of the stock changes between the time the buyer purchases and sells a stock. A **stock split** occurs. This means, if there is a 2 for 1 split and an individual owns one share worth \$100.00 after the split, the individual will own two shares worth \$50.00 each. After a split, the value of a stock generally increases. A merger (joining) of two companies occurs causing a change in the stock price. **Dividends** are distributions of earnings a corporation pays to stockholders. They are paid in the form of cash, company products, property, discounts, and additional stocks.

Preferred stock refers to shares which pay fixed dividends and have precedence over common stock. Because of this priority, preferred stock has less risk than a common stock.

Individuals do not have a vote to determine the company's board of directors. Dividends for each stock are stated as a percentage known as the **par value**. This value is a fixed percentage stated on the stock certificate. If a \$100.00 stock has a par value of 6%, the dollar amount would be \$6.00 per dividend period. The **market price**, amount a willing buyer would pay a willing seller for the stock, is based upon interest rates of the economy. If interest rates increase, the market price decreases so the stock remains competitive with other investment options. Typically a person can find this information in the business section of a newspaper or on the internet.



COMMON STOCK CLASSIFICATIONS

For an investor to have a diversified stock portfolio, he/she must have a variety of stocks which fall into different categories. There are seven basic classifications for common stocks.

GROWTH

Growth stocks are from companies who have a consistent record of relatively rapid growth and earnings in all economic conditions. They are generally new companies expanding their product line by retaining all income and therefore pay no dividends. Income can be earned from an increase in market price. The beta is 1.5 or higher.

INCOME

Income stocks pay higher than average dividends because the company chooses to retain only a small portion of its profits. These stocks are attractive to investors who are interested in receiving dividends and are not worried about selling the stock at a higher market price. These stocks are from companies who have a steady stream of income such as utility companies. The beta is less than 1.0.

VALUE

Value stocks are from companies which have a low market price considering their historical earning records and value of current assets. They are often viewed as investment bargains. Previous examples have included Time Warner and IBM.

COUNTERCYCLICAL

Countercyclical stocks (defensive) are companies which give consistent returns even when the economy is suffering because their products are always in demand. They are good for investors who are always looking to receive dividends. Examples include tobacco companies, utility companies and grocery stores. The beta is 1.0 or below, even in the negative.

CYCLICAL

Cyclical stocks are greatly influenced by changes in the economic business cycle. If the economy is doing poorly, so is the stock. They are companies which operate in major consumer dependent industries such as automobiles, housing, or airlines. The beta is generally 1.0.

SPECULATIVE

Speculative stocks are from companies with potential for substantial earnings in the future. These stocks are very high risk, but very profitable if the company grows. The company has a very spotty earnings pattern or is so new an earnings pattern has not yet emerged. Internet, genetic engineering, and video game companies are examples of speculative companies. Microsoft was once a speculative company and is now a growth stock. The beta is 2.0 or higher.

BLUE CHIP

Blue-chip stocks are from nationally recognized companies which dominate the industry often having annual revenue of \$1 billion or more. They have long records of profit, dividend payments, and a good reputation for the company management, products, and services. These stocks are generally higher priced but less risky because they are expected to grow at a consistent rate. McDonalds, General Motors, and General Electric are examples of blue-chip stock companies.

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RESEARCHING A STOCK

There are four numerical measures an investor may use to determine how well a company's stock is doing.

1 Book value is the net worth of a company. It is determined by subtracting a company's liabilities from its assets. These numbers can be found in the company's annual report. The number indicates what would happen if a company's assets were sold, debts paid off, and all proceeds were distributed to those who own shares of common stock.

Formula

$$\text{Assets} - \text{Liabilities} = \text{Book value}$$

Example

$$\$154,000,000 - \$72,000,000 = \$82,000,000$$

2 Earnings per share (EPS) indicates how much income a company has available to pay in dividends and reinvest as retained earnings on a per share basis. This indicator is highly regarded as an important statistic to evaluating a stock because it indicates how well a company is doing overall. It is determined by dividing the corporation's after tax annual earnings (before common stockholders are paid but after dividends are paid to preferred stockholders) by the total number of shares of common stock. These numbers can be found in the business section of many newspapers.

Formula

$$\frac{\text{After tax annual earnings}}{\text{Total number of shares of common stock}} = \text{Earnings per share}$$

Example

$$\frac{\$15,500,000}{7,620,900} = \$2.03 \text{ earnings per share}$$

3 Price/earnings ratio (P/E ratio) is the relationship between the price of one share of stock and the annual earnings of the company. It is the most widely used and critical measure of a stock's price. It represents how much investors are willing to pay for each dollar of a company's earnings. Most companies' P/E ratio is 5 to 25. Financially successful companies have a ratio of 7-10, rapidly growing companies are between 15-25, and speculative companies are 40-50. Lower P/E stocks pay higher dividends, have less risk, lower prices, and slow growth. High P/E ratios indicate a firm is expected to have a lot of growth in the future. Information can be found in a newspaper.

Formula

$$\frac{\text{Price per share}}{\text{Earnings of the stock}} = \text{P/E ratio}$$

Example

$$\frac{\$43.00}{\$2.03} = 21 \text{ P/E ratio}$$

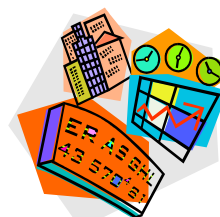
4 Beta measures a stock volatility compared to changes in the overall stock market. If a stock has a beta of +1.5 and the market went up 10%, it is expected the value of the stock would rise 15%. Conversely, if the market dropped 10%, a +1.5 beta stock would drop 15%. Stocks have an average beta between +0.5 - +2.0. A negative beta indicates a countercyclical stock because the price changes are opposite the movements in the business cycle. Conservative investors want a stock with a beta of +1.0 or less meaning the stock is less sensitive to changes in the market. A beta of +1.1 - +2.0 indicates the stock is more sensitive to changes in the market because it moves at a greater percentage. A higher beta indicates a greater risk. Beta can be found by doing an internet search for "company ticker symbol + beta."

READING STOCK QUOTES

The following descriptions are possible elements to be listed for stock quotes. Each chart may vary. For example, the Wall Street Journal does not include the High and Low numbers for the reported day whereas local newspapers may. The Wall Street Journal is the most widely read financial newspaper responsible for reporting daily transactions.

①	②		③	④	⑤	⑥	⑦	⑧		⑨	⑩
YTD %	52-Week		STOCK	DIV	YLD %	P/E	VOL 100s	HIGH	LOW	CLOSE	NET CHG
	HIGH	LOW									
-50.6	14	4.15	AAR	.10	2.2	30	1479	4.51	4.40	4.45	0.27
-11.0	19.75	12.48	ABM	.36	2.6	21	1913	14.01	13.85	13.95	0.10
-27.3	20.44	10.57	ABN	.82e	6.9	...	4397	11.93	11.79	11.84	0.72
-26.0	44.98	22.01	ACE	.68	2.3	2	17128	30.10	29.65	29.73	-0.04

- YTD% - Year to date percent change** is the stock price percent change from January 1st of the current year.
- 52-WEEK HIGH & LOW** - Shows the highest and lowest prices the stock was sold per share during the last 52 weeks.
- STOCK** - Each company's stock is provided with an abbreviated trading symbol name.
- DIV - Dividends per share** is the total cash paid to common stockholders per share. It is based upon annual payments. An "e" next to the number indicates dividends have been paid in the previous year, but not on a regular basis. If a company paid \$10,000 in dividends for 30,000 shares, the dividends per share would be \$0.33 (10,000/30,000). This is helpful when determining the type of stock. An individual looking for an income stock would want to ensure high dividends are paid.
- YLD% - Dividend yield percentage** is the dividend expressed as a percentage of the price of the share. If a company paid \$1.25 in dividends for a stock with a market price of \$50.00, the dividend yield percentage would be 2.5% (1.25/50.00).
- P/E - Price/earnings ratio** is the closing price of the share compared to the annual earnings per share. If a stock's market price is \$50.00 and the earnings per share are \$2.25, the P/E ratio will be 22.2 (50.00/2.25) or 22 to 1. This means for every dollar the company earns, the stock's market price is worth \$22.00. This shows how the market values a stock because it describes how much investors are willing to pay for each dollar of earnings.
- VOL 100s** - This is the number of transactions to the share on the reported day, represented in hundreds (take the number and add two zeros).
- HIGH & LOW** - These entries represent the high and low selling prices of one share of stock for the previous day.
- CLOSE** - This is the price of the last share sold for the day.
- NET CHG - Net Change** is the difference between the closing price of the share from the prior day and the current day. A loss is indicated by a minus sign.



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STOCK MARKET INDICATORS

There are three basic indexes which track stocks and give individuals a sense of the general health of the economy.

The Dow Jones Industrial Average began in 1884 and is the oldest indicator of the ups and downs of the stock market. It was named after a cofounder, Charles H. Dow, and is nicknamed the Dow. It lists the 30 leading industrial blue chip stocks

www.djindexes.com

The Standard & Poor's 500 Composite Index covers market activity for 500 stocks. It is more accurate than the Dow because it evaluates a greater variety of stocks.

www.standardandpoors.com

The NASDAQ (National Association of Security Dealers Automated Quotations) monitors fast moving technology and financial services stocks. It covers the market activity for all stocks traded on the NASDAQ. Because the NASDAQ monitors smaller companies with a more speculative stock it generally has more dramatic ups and downs compared to the Dow.

www.nasdaq-amex.com

BROKERS

A **broker** is a person who is licensed to buy and sell stocks, provide investment advice, and collect a commission on each purchase or sale. A broker buys and sells stocks on the stock market (organized exchange). Over three-fourths of all stocks are bought and sold on an organized exchange. Each exchange has minimum requirements for a stock to ensure only reputable companies are used. The minimum standards include an evaluation of annual earnings before taxes, net assets, market value, number of common shares offered to the public, and number of stockholders owning 100 or more shares. Each exchange has a limited number of seats available which brokerage firms may purchase to give them the legal right to buy and sell stocks on the exchange.

ORGANIZED EXCHANGES

The New York Stock Exchange (NYSE) began in 1792 and is the largest exchange with the strictest company standards. There are 1,366 broker seats available to trade shares for the 2,800 companies who offer stocks on the NYSE. The average stock price is \$33.00.

www.nyse.com

The American Stock Exchange (AMEX) began in 1849 and is the second largest exchange. It differs from the NYSE because its requirements are not as strict allowing it to list younger, smaller companies. The average stock price is \$24.00.

www.amex.com

Regional Stock Exchanges trade stocks to investors living in a specific geographical area. Regional exchanges include Boston, Cincinnati,

Intermountain, Midwest, Philadelphia, and Spokane.

National Association of Securities Dealers Automated Quotations (NASDAQ) Not all stocks are listed on a securities exchange. Some are sold in the over-the-counter market. These stock transactions are negotiated through a sophisticated telecommunication network run by the NASDAQ. The NASDAQ has more than 4,000 small United States and foreign companies listed. The company requirements are not strict. The NASDAQ works by having two brokers negotiate a stock's purchase and selling price. The price at which a stock is sold is the lowest price any broker will accept at the time. The average stock price is \$11.00

www.nasdaq.com



THE UPS AND DOWNS

The term **bull market** describes the state of the economy when the market is doing well and investors are optimistic about the economy and are purchasing stocks. A bull market occurs when prices have risen 20 percent or more over time. On average, the bull markets last 29 months at a time.

The term **bear market** describes the state of the economy when the market is doing poorly and investors are not confident in the economy. Therefore, they are not purchasing stocks or are selling stocks already owned. It is characterized by a 20 percent decline from previous highs. On average, the bear markets lasts 9 months at a time.

BEHIND THE SCENES

When a person has chosen a stock he/she would like to purchase, they may purchase it on their own, however there are some practical and legal problems which can occur. The stock market is a highly regulated exchange allowing only those who are properly registered and licensed to buy and sell stock.

When individuals think of a stock exchange, they imagine this scene of frantic activity, people yelling, making strange hand signals, and papers flying. However, the stock exchange is actually a very methodical and organized system. Buyers and sellers are meeting to compete for the best price for their customers. It is based upon the laws of supply and demand. A trade occurs when the highest bid meets the lowest offer to sell.

HOW A STOCK IS BOUGHT AND SOLD

